

**ACQUISITION BY BAI OF CERTAIN ASSETS OF P&O
DEPLOYED ON THE PORTSMOUTH/LE HAVRE ROUTE –
PRELIMINARY COMMENTS OF P&O TO THE ISSUES PAPER
CONCERNING THE MAIN SUBSTANCE**

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1. **References are to the numbered paragraphs in the OFT's Statement of Issues letter**
2. **The lack of quantitative evidence of the impact of LCAs/high speed trains upon ferry price setting/competition**

We attach below an extract from P&O's tourist price setting paper. It is impossible to make a scientific cross-correlation between ferry and LCA/high speed train prices – yet (see the main submission, also set out below) there is a discernable LCA impact upon overall tourist cross-Channel volumes. It is clear that all commentators (operators, analysts and the specialised and general press) cannot be wrong on the issue of the increasing LCA competitive constraint. For the growing impact of high speed rail on LCAs and ferries, see last Friday's (19 November 2004) Times article "**French rail takes on cheap flights**" (attached as Annex 1).

The Office draws a negative conclusion from a lack of quantitative evidence which is per se unobtainable. P&O monitors the impact of LCAs/high speed trains through overall volume shifts. That is the only practicable means in a sector where common pricing points across transport modes do not currently exist and where precise monitoring is therefore impossible. The following extract from P&O's price setting paper of 12 November 2004 makes the analysis and point succinctly.

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[CONFIDENTIAL – CONTAINS BUSINESS SECRETS]. Here is a quite clear "impact" and this demonstrates the evolutionary nature of the process – once fare structures and marketing approaches are more co-ordinated, the existing competition will not only intensify, but become more measurable. Last Friday's Times article shows that French high speed trains are adopting LCA pricing, thus bringing high speed trains firmly into the equation (attached at Annex 1).

We are concerned that the OFT is taking a one dimensional, non-dynamic view of the LCA impact issue. It is a recent (primarily post 2002) and fast moving phenomenon, with the outlook clearly being one of a materially strengthening constraint. The general public is being constantly reminded of this constraint by the general and specialised press and other media (such as transport related internet search engines and ITX brochures).

3. **No EC or UK precedents of value on the Western Channel market(s)**

The Office is referred to the conclusions of the Monopolies and Mergers Commission ("**MMC**") in its decision in relation to the formation of P&O Stena Line at paragraphs 5.62 and 5.64 where after an in-depth investigation, the MMC concluded **in relation to freight** that the Short French Sea freight routes offer: *"... a substantial degree of substitutability for ... Western Channel ... routes"*. The freight market has experienced no equivalent step change in conditions of competition and therefore, in relation to freight, the MMC conclusions are considered to be of real precedent value.

4. **The drive time and drive cost analyses.**

The drive time and drive cost studies only address tourist services. The economics of the logistics for freight would be both more complex and different.

P&O has put in a good deal of evidence of freight switching in its 12 November 2004 submission.

The Office takes a somewhat static approach to the Short French Sea competitive constraint on the Western Channel issue, suggesting that those tourists who would switch **have already done so**, leaving a hard core of inelastic, non-price sensitive Western Channel customers (later identified as long stay customers). This fails to take account of the events of Summer 2004 on the Short French Sea where, effectively, a new maximum price benchmark of £100 return has been set for the peak season and the impact that this benchmark did have on the Western Channel in 2004 (see P&O's analysis of this impact upon its Western Channel services, the "£96 paper"). It is inconceivable that the price war on the Short French Sea will not have a similar, and in fact, most probably, far greater impact in 2005. The media, see above, must be expected to continue to emphasise the choices available to consumers and therefore consumer awareness will increase.

The drive times and drive costs studies on the economics for tourists of using a Short French Sea alternative to the Western Channel routes, emphasises the **feasibility** of switching to the Short French Sea. **[CONFIDENTIAL – CONTAINS BUSINESS SECRETS]**. The media coverage – last Friday's Times article (Annex 1) – the Sunday Times on 5 September 2004 suggest that the Short French Sea constraint must surely strengthen. In its September article the Times concluded:

"Cut-throat competition between cheap airlines, new ferries and high speed trains means the cross-Channel hopper has never had it so good."

- 4(b) We strongly question the Office's reliance upon the P&O Henley Centre survey as contrary evidence to the considerable body of positive evidence that P&O has put forward in relation to actual and potential tourist switching between the Western Channel and Short French Sea.

The positive evidence put forward includes:

- the detailed analysis of alternative drive times and drive costings (main submission of 8 October 2004 and supplementary submission of 29 October 2004);
- the evidence of the willingness of tourists to undertake long drive times in the UK to get to the Short French Sea ports (submission of 19 October 2004);
- the 2004 tourist switching data recording the fact that dual P&O users of Western Channel and Short French Sea services switched the majority of their purchasing to the Short French Sea in 2004 (submission of 29 October 2004);
- the evidence of incentives being given to P&O ITX customers to sell less attractive ITX services on the Western Channel (submission of 12 November 2004).

In considering the Henley Centre customer survey as contrary evidence of a tourist propensity to switch to the Short French Sea, it is at once **notable** that the survey sample concerned only those who had switched between P&O's and BAI's Western Channel routes, **i.e. the survey self-selected against customers who might have considered a switch to the Short French Sea.** On that basis alone, we do not think that the survey can be used as evidence against the practice and/or potential for tourist switching to the Short French Sea. In addition, it is clear from the content of the Henley Centre report as a whole, that it is aimed exclusively at understanding better the narrow issue of substitution between BAI and P&O on the Western Channel, hence the narrow ambit of the survey referred to above.

4(c) It is striking that the French Government study upon which the Office appears to place heavy reliance is some six years out of date. It thus precedes the:

- loss of duty free;
- the growing impact of LCAs and high speed trains;
- the full development of Eurotunnel's service and market share¹ and the overhang of excess capacity on the Anglo/French market;
- the development of direct internet sales;
- the proliferation of cross-Channel transport modes (sea, air, rail) and media attention and public awareness of the same.

In a highly dynamic industry, and with a wealth of more recent data and external reports (provided to the Office), we are very surprised that such emphasis is placed upon this single out-of-date report.

It must be observed that in the duty free era, the Short French Sea derived a significant proportion of its profits from duty free sales and that it could and did stimulate tourist market volumes by offering very low ticket prices (as low as £1), in the knowledge that a positive margin would be made as a result of substantial on-board spend by customers (on board duty free spending offering a very high profit margin). The Western Channel, with far longer routes and lower rates of vessel utilisation² did not have the same capacity to exploit the duty free regime, therefore ticket revenue remained proportionally more important. Therefore, the mix of fares between the two sectors will have been without doubt quite different and mix, self-evidently, will have a big impact on the final, overall average car price, that the report focuses upon. In short, we believe that the tourist price divergence that the report purports to identify is flawed by issues of product and price "mix".

In relation to relative freight price movements between the Western Channel and Short French Sea over time and the bearing that such price movements have upon competition and market analysis, the Office is referred to the MMC's conclusions on this issue in P&O Stena Line (see paragraph 3 above). Since the MMC were carrying out an in-depth competition analysis of the Anglo/French freight sector in its report, we consider that this report is to be preferred to that of the French Government, which report was carried out for the purpose of accessing future infrastructure investment.

In summary, it would be quite meaningless to attempt to apply "findings" from a report rooted in the duty free era of the mid-1990s and largely before the full impact of the Channel Tunnel³ to the current **post** duty free tourist market.

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4(f) **No supply-side switching between the Short French Sea and the Western Channel**

P&O would agree with this finding. It has **never** occurred. It is highly unlikely – the Short French Sea is the premier geographic sector for both tourist and freight ferry services - shortest crossing time, best road connections, most choice, most convenience, the only sector able to offer a "turn-up and go" flexibility – the only sector with a weather immune alternative (the Tunnel). Short French Sea multi-purpose vessels could not simply be switched to the Western Channel since they would not have sufficient accommodation. Short French Sea vessels have been built to maximise on-board sales and catering/amenities and have only minimal accommodation for an approximately one hour 15 minute crossing.

¹ Eurotunnel's services were brought to a halt for several months by the Tunnel fire in 1997.

² In 1993-1998, there were no fastcraft. The less vessel utilisation, the less frequent the introduction of new on board shoppers. Western Channel vessels can achieve a maximum of two round trips per day, versus five to six on the Short French Sea.

5. **The constraint of LCAs on Western Channel tourist services**

P&O considers that the economics of longer term car hire would still make the LCA a powerful constraint, particularly as the longer stay ferry crossing is materially more expensive than a short stay crossing and thus allows more margin over an LCA fare for the cost of car hire. In addition, the Office ignores the likelihood that regular, second-home owner travellers, will keep a second car in France.

7. **The French Government study**

The loss of duty free has had a very strong depressing effect upon day trip passengers, especially on the Western Channel. Therefore, immediately, the relevance of this study and its categorisation of long stay, short stay and day trip customers must be called into question when analysing today's tourist market (and looking forward).

P&O cannot accept that long stay customers (anymore than any other category of customer) are price insensitive. As illustrated above and in the main submission, the travelling public is now being constantly reminded by the media of the cost attractions of alternative modes of travel to France. P&O's evidence in relation to the impact upon its Western Channel volumes of the 2004 peak season £100 fare on the Short French Sea, indicates, contrary to the Office's findings, that long stay peak season customers **are** price sensitive. With the media focus on this issue, and the **real** existence of Short French Sea alternatives, this sensitivity cannot realistically be expected to diminish.

8. **Does the structure of tourist ferry pricing help establish that long stay tourists are price insensitive?**

[CONFIDENTIAL – CONTAINS BUSINESS SECRETS]. Demand was invariably stimulated during periods of weak demand, i.e. outside the Summer peak of the school holidays (July to end August). Therefore, the duration approach to pricing was aimed primarily at overcoming seasonality and stimulating demand and revenue in non-peak periods through low fares and high margin on-board sales. **[CONFIDENTIAL – CONTAINS BUSINESS SECRETS]**.

9. **Will the merger harm long-stay customers?**

As noted above, P&O can see no basis for a finding that long-stay customers are or will be price-insensitive. The drive-time and drive cost analyses show the feasibility of switching between the Western Channel and the Short French Sea; **[CONFIDENTIAL – CONTAINS BUSINESS SECRETS]**.

10. **Entry and expansion**

³ As noted above, the Channel Tunnel commenced services in 1995, but its performance was disrupted by a fire in 1997.

P&O largely endorses the Office's findings on entry/expansion:

- the existence of high sunk costs, especially in tourist;
- the disincentive created by the Short French Sea excess capacity overhang (which shows clear signs of increase, not decrease);
- the disincentive created by the fact that the incumbent (BAI) has already announced entry/expansion into Caen and Cherbourg for 2005;
- as the Office states, no Short French Sea operator has ever switched to the Western Channel (why would they since it is a more marginal sector?) and as pointed out above, Short French Sea vessels would be unsuitable for use on far longer routes requiring substantial accommodation;
- entry by means of a multi-purpose ferry is particularly unlikely given the costs, risks and expenditure required operationally;
- given the Office's conclusion that fastcraft could not offer the accommodation and leisure facilities that Western Channel customers require, it must logically reach the same conclusion in relation to ropaxes, which offer only basic/no frills on-board tourist amenities (the emphasis of such vessels being on freight services). P&O does not consider that such vessels would be suitable for 6-8 hour Western Channel (overnight) crossings and notes that no operator has ever sought to introduce ropaxes on the Western Channel.

11. **Tourist customer buyer power**

We are surprised that the Office has not recognised the buyer power and choice (between Western Channel and Short French Sea services) of ITX, coach and group and bucket shop purchasers (as set out in the main submission of 8 October 2004, see pages 58 and 59).

13. **Benefits**

An extrapolation of entry prospects from the Irish Ferries case is inappropriate, in particular where much of the current concerns relate to tourist services. The Irish Ferries case was focussed exclusively upon freight and concerned the principal Anglo/Ireland central freight corridor. Conditions of competition on that market were quite different from those on the Western Channel. In particular there was no overhang of a higher volume, higher convenience, lower priced alternative collection of routes. Accordingly, we do not consider that any general entry/expansion proposition can sensibly be transported from the Irish Ferries case to the present case.

The question to be answered in this case is: **who will enter?** The Office itself has largely answered that question with a series of very pessimistic findings on entry/expansion with

which P&O can largely concur (paragraph 10 of the Statement of Issues). The Office does not refer to the fact that BAI has already announced entry/expansion on Caen and Cherbourg in 2005 (which is an important additional evidential factor on this issue).

The Office's dismissal of the benefits of the current transaction depend entirely upon a positive view of entry which it has earlier dismissed in the Statement of Issues.